Tax Reform

May 2014

Congress Should

- Refine depreciation periods to more accurately reflect the average service lives of equipment
- Reform existing energy efficiency tax incentives
- Promote capital investment in manufacturing
- Consider establishing a price on emissions if additional revenues are needed to reduce marginal tax rates to desired levels

The Issue

Both Democrats and Republicans are interested in tax reform that simplifies the current tax code, reduces marginal tax rates and is part of a long-term strategy that gets the federal debt under control. To promote the smooth functioning of markets, tax reform should also remove barriers to efficiency investments embedded in the current tax code, and to use the tax code as a tool to transform markets so that energy efficiency investments can grow. In an ACEEE report, *Tax Reforms to Advance Energy Efficiency*, we suggest tax policies in six areas that should be used to encourage energy efficiency.

Summary

Business Depreciation Rates: Depreciation rates in the current tax code are often longer than the economic life of equipment. This means that equipment is still being depreciated when it should be replaced, providing a disincentive for replacing the equipment. For example, in today's tax code, most commercial building equipment is depreciated over 39 years, which has been a disincentive to replace existing rooftop air conditioners and other building equipment that have shorter lives (e.g., 15 years). More realistic depreciation rates are needed. Likewise, in the industrial sector, depreciation rates can vary for the same equipment depending on how the equipment is used. These rates need to be rationalized into a single set of rates that reflect market reality. Congress should rationalize rates as part of tax reform and direct the IRS to periodically review and revise depreciation rates based on the latest market data.

Reform Tax Incentives to Target 'Super-Efficient' Products and Services that Seek to Transform Markets: Some of the current tax incentives have been very effective in moving markets, allowing the incentives to be revised or phased out. Other incentives have been expensive and do not drive market changes. Future incentives should target the most efficient products and services and should include a mechanism to periodically update qualification levels. We recommend targeting such incentives to very efficient new homes and commercial buildings, and to retrofits of existing homes and commercial buildings that reduce energy use by at least 20%. Ultimately the incentives can be phased out, when markets are strong enough to prosper without incentives.

Spur capital investment in manufacturing: Much of the equipment and many of the production processes in America's factories are decades old, and not as efficient as the modern equipment and processes used by many of our international competitors. Modernizing these factories will allow them to better compete in world markets by improving product quality and reducing costs, including through reduced energy use. As we emerge from the Great Recession, many industrial firms have capital to invest, but a nudge from the tax code could spur substantial additional investments here in the U.S. We suggest three possible tax strategies that would spur investment at a low cost to the Treasury:

a. Provide a low tax rate for repatriation of company profits *provided* these repatriated profits are used to increase a company's capital investments relative to their average capital investments in recent years (e.g., a three-year rolling base period).
b. Allow accelerated depreciation on *increased* capital investments in production capacity, allowing companies to reduce their near-term taxes.

c. Provide repayable tax incentives for increased capital investments. The credit would be taken on taxes in the year the expenses were made, but then the credit would be paid back to the Treasury in subsequent years.

The first approach would benefit only large multinational firms, and therefore the second or third approach should also be included in order to benefit firms that primarily serve the domestic market. A firm would only be able to use one of the approaches.

Add a price on emissions: Our present tax system largely taxes things that result from productive economic activity—wages, non-wage income, and corporate profits. An alternative is to collect some revenue from things that produce negative economic effects, such as cigarettes, alcohol, and pollution. Many prominent economists and politicians have spoken in favor of using taxes to regulate pollution. We are not suggesting that all revenues be collected from such taxes but adding such taxes to the revenue mix can allow income taxes to be reduced. In the context of tax reform, if efforts to reduce current tax breaks are not sufficient to reduce marginal tax rates to desired levels, the revenue from emissions taxes could be a route to achieving the desired rate reductions.

For More Information

- *Tax Reforms to Advance Energy Efficiency*: http://aceee.org/research-report/e132
- More tax reform resources: http://aceee.org/topics/tax-reform

ACEEE Contacts

Steven Nadel
snadel@aceee.org